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1501 K STREET, N.W.
WASHINGTON, D.C. 20005
TELEPHONE 202 736 8000
FACSIMILE 202 736 8711
www.sidley.com

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WRITER'S DIRECT NUMBER
(202) 736-8088

WRITER'S E-MAIL ADDRESS
dlawson@sidley.com

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Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th St., SW
Washington, D.C. 20554

Re: CC Docket Nos. 93-193, 94-65 and 94-157

Dear Ms. Dortch:

I write on behalf of AT&T Corp. ("AT&T") in response to Verizon's latest *ex parte* arguments that Verizon should be permitted to keep overcharges resulting from unlawful 1996 exogenous cost rate hikes that Verizon based on retroactive restatements of its 1992-1995 rate bases.[1]

Specifically, Verizon and the other Bells in 1996 recalculated their rate bases for 1992-1995 by reversing earlier deductions of zero-cost, non-investor supplied funds represented by the "other post-retirement benefits" or "OPEB" liabilities recorded in their regulatory books in those years. The Bells, using those adjusted rate bases, computed how much more they could have charged AT&T and other rate-payers through reduced overearnings sharing obligations in those years. The Bells then added those amounts to their 1996 rates through "exogenous cost" increases to their 1996 price cap indices ("PCIs"). Thus, Verizon and the other Bells' recovered in their 1996 rates amounts that they claim they could have charged, but did not charge, in prior years. The Commission immediately recognized that "the LECs' rate base treatment of OPEBs raises a substantial question of lawfulness under existing rules" and accordingly suspended the

[1] Letter from Joseph Mulieri (Verizon) to Marlene H. Dortch (FCC), CC Docket Nos. 93-193, 94-65 and 94-157 (dated May 24, 2004) ("*Verizon May 24 Letter*"); Letter from Joseph Dibella (Verizon) to Marlene H. Dortch (FCC), CC Docket Nos. 93-193, 94-65 and 94-157 (dated May 13, 2004) ("*Verizon May 13 Letter*").

Bells' tariffs and set them for investigation in this still-pending proceeding. Memorandum Opinion and Order, *1996 Annual Tariff Filings, et seq.*, 11 FCC Rcd. 7564, ¶ 19 (1996).

The Bells' 1996 exogenous cost increases were unlawful. Those increases violated the Commission's exogenous cost rules (47 C.F.R. § 61.45) and a 1995 Commission order that prohibits LECs from seeking exogenous cost increases for OPEBs and other accounting changes that have absolutely no impact on cash flow.[2] The exogenous cost increases were also unjust and unreasonable in violation of 47 U.S.C. §§ 201 & 202. *Id.*

During the past eight years of the Commission's investigation into Verizon's and the other Bells' exogenous cost increases, Verizon has offered various baseless arguments attempting to justify those patently unlawful increases. In its May 13 and 24, 2004 *ex partes,* Verizon proffers yet another new and equally baseless argument. Verizon now asserts that its 1996 tariffs are *per se* lawful because, according to Verizon, the Commission's rules required Verizon to implement the exogenous cost increases in its 1996 tariffs. *Verizon May 24 Ex Parte* at 1-5 ("when a carrier complies fully with the Commission's price cap rules, its rates are just and reasonable by definition, and the Commission cannot rely on § 201(b) [of the 1996 Act] in a tariff investigation, to circumvent the statutory requirements for amending, and for modifying its interpretation of, its regulation"). As demonstrated below: (1) it is well-established that a tariff is *not per se* lawful merely because it complies with the price cap rules, and (2) in any event, it is not true that the Commission's rules or orders required – or even permitted – Verizon to implement the 1996 exogenous cost increases. Verizon's further claim that equitable considerations nonetheless favor allowing Verizon and the other Bells to keep the overcharges is frivolous.

A Tariff Is Not Per Se Lawful Merely Because It Does Not Violate A Price Cap Rule. Verizon's claim that its 1996 tariffs are *per se* lawful because they complied with the Commission's 1996 price cap rules is baseless. The Commission expressly rejected that precise argument in 1991, immediately after adopting the price cap rules. Order On Reconsideration, *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd 2637, ¶¶ 203-206 (1991) ("*Dominant Carriers Order*"). "U S West contend[ed] that 'there is no such thing as an unlawful rate based on overearnings in a price cap environment when . . . all price cap rules are adhered to.'" *Id.* ¶ 203 (quoting a U S West Petition). The Commission expressly rejected that argument, stating that "we find no adequate support for th[at] absolutist view." *Id.* ¶ 206. The Commission emphasized that "[t]he possibility remains . . . that rates for specific services may be

[2] Letter from David L. Lawson (AT&T) to Marlene H. Dortch (FCC), CC Docket Nos. 93-193; 94-65 and 94-157 (filed March 15, 2004); Letter from David L. Lawson (AT&T) to Marlene H. Dortch (FCC), CC Docket Nos. 93-193; 94-65 and 94-157 (filed April 13, 2004); Reply Comments of AT&T, at 3-6, 12-16, CC Docket Nos. 93-193; 94-65 and 94-157 (filed April 22, 2003); Comments of AT&T, at 5-39, CC Docket Nos. 93-193; 94-65 and 94-157 (filed April 8, 2003).

set at unreasonable levels, or be unlawful in other ways" and "compliance with the price cap rules does not necessarily make this impossible." *Id.; see also* Memorandum Opinion And Order On Reconsideration, *1997 Annual Access Tariff Filings*, 13 FCC Rcd. 10597, ¶ 7 (1998) ("Even under price cap regulation, carriers bear an obligation under the Communications Act to tariff just and reasonable rates"); Memorandum Opinion and Order, *Bell Atlantic Telephone Companies Revisions to Tariff F.C.C. No. 1, et seq.*, 6 FCC Rcd. 4891, ¶¶ 9-10 (1991) (noting that compliance with the price cap rules is "not the sole criteria on which the lawfulness of a rate in a tariff investigation or complaint proceeding is resolved"). The D.C. Circuit also has recognized that "even streamlined tariffs [which comply with the price cap rules] do not escape FCC scrutiny; [carriers] . . . can petition for review of any streamlined tariff that it believes unreasonable." *National Rural Telecom Association* v. *FCC*, 988 F.2d 174, 185 (D.C.Cir. 1993).

Verizon ignores these consistent holdings and instead relies on out-of-context snippets from ¶ 202 and footnote 211 of the *Dominant Carriers Orders*, apparently hoping that the Commission will not bother to read those orders. Those portions of the *Dominant Carriers Order* merely suggest that a complaint challenging a carrier's tariff *solely* on the ground that the carriers' earnings are too high would be foreclosed if the carrier complied with the Commission's price cap rules. *Id.* ¶ 202 ("[a] complaint against a price cap carrier that is based solely upon the theory that rates are unjust and unreasonble because the rates produced [high] . . . earnings would be dismissed"); *id.* n.211 ("Only filings that make price changes within cap and band limits are presumed lawful and streamlined, and even filings that are subject to streamlining may be investigated. The only complaints foreclosed by price cap regulation are those based upon total interstate earnings"). These provisions clearly have no application here because Verizon's tariffs are being investigated not solely because Verizon's total interstate earnings were too high, but because Verizon's rate base-generated exogeneous cost increase to its PCIs was unjust and unreasonable (and, indeed, as detailed in prior AT&T submissions (*see* n. 2, *surpa*), in direct violation of the Commission's rules), resulting in tens of millions of dollars of unjustified rate increases for specific interstate services.[3]

Verizon suggests that even if the Commission is not absolutely barred from assessing whether rates that comply with the price cap rules also comply with the Act's just and reasonable rate requirements, the Commission has stated that it will do so only where the price cap rules do not identify the "precise steps" for computing a rate. *Verizon May 24, 2004 Ex Parte*, at 4. But, as noted, when the Commission addressed this issue in the *Dominant Carriers Order*, it did not purport to limit its authority or willingness to reject unjust and unreasonble rates, even if the rates otherwise complied with the price cap rules. And Verizon identifies no Commission rule or order to the contrary. Verizon only refers the Commission to cases where, according to Verizon, there *was* an ambiguity in the Commission's rules, and the Commission

[3] The other orders cited by Verizon (at 2-3) merely state that the Commission's price cap rules were designed to produce just and reasonable rates, and thus compliance with those rules is necessary to produce just and reasonable rates. But those orders do not even remotely suggest that mere compliance with the price cap rules is *sufficient* to produce just and reasonable rates.

warned that when carriers' resolve such ambiguities in setting rates, the Commission will vigilantly monitor whether the carriers' did so in a manner that complies with the just and reasonable standards. Nothing in those cases purports to limit the Commission's authority to monitor whether rates are just and reasonable to *only* such cases.

But even if (contrary to law), the Commission's authority was so limited, that condition is satisfied here. As noted, Verizon and the other Bells' retroactively recomputed their rate bases to reverse prior years' OPEB deductions. Nothing in the price cap rules expressly authorizes such retroactive restatements. On the contrary, to the extent that the Commission's rules even address restating the rate base, the Bells' can do so only for the *current* rate base using updated data from the past *15 months* – not for prior year rate bases using data as much as *four years* old, as the Bells did in 1996. 47 C.F.R. § 61.3(e). And even if the Commission's rules did address and permit the Bells to restate prior year rate bases, the Commission's rules do not expressly authorize the Bells to implement exogenous cost increases to the current year's PCIs to recover potential differences in revenues based on the restated rate bases. Those Part 61 rules *preclude* the Bells from implementing such exogenous cost increases. Thus, even under Verizon's cramped theory – where the Commission is limited to applying the just and reasonable standard only in cases where its price cap rules do not identify the "precise steps" for computing rates – the Commission has ample authority to apply that standard here.

And the Commission *has in fact determined* that rates computed using a rate base that reflects unfunded OPEB amounts – as Verizon and the other Bells did in 1996 – are unjust and unreasonable because such amounts are the type of "zero-cost sources of funds" that the Commission routinely has determined cannot, consistent with the requirements of the Act, be included in carriers' rates. Report and Order, *Responsible Accounting Officer Letter 20, Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32, et seq.,* 12 FCC Rcd. 2321, ¶ 19 (1997) ("*Zero-Cost OPEB Order*"). It is thus already well-established that raising rates on the basis of prior OPEB accounting changes is unjust and unreasonable.

Verizon purports to advance a "new" argument that unfunded OPEBs are not really zero-cost sources of funds. But this "new" argument was first advanced by Verizon's predecessor, Bell Atlantic, and others in the proceeding that resulted in the *Zero-Cost OPEB Order* and, based on the full record addressing that issue, the Commission properly rejected the that argument. *Zero-Cost OPEB Order* ¶¶ 16-17. Specifically, Verizon argues here, as it did there, "that OPEB and other Account 4310 amounts are not rate-payer supplied funds because these amounts were not factored into price cap rates" and that "only those items that have been included in the rates should be removed from the rate base." *Id.* ¶ 16. The Commission was "not persuaded by the argument that amounts recorded in 4310 are investor-supplied funds because they were not factored into pre-price cap rates or have not been given exogenous treatment." *Id.* ¶ 17. "To the extent that carriers are earning a positive return on assets funded in part by the liabilities recorded in 4310, these carriers are recovering their costs." *Id.*[4] Indeed, Verizon's

[4] Verizon criticizes these Commission findings because they were made "without explanation." *Verizon May 24, 2004 Ex Parte,* n.13. But the substantial record in that proceeding fully

argument that its PCIs were never reflected OPEBs is a red herring. The issue is whether the *rate base* on which reasonable returns are computed to determine the Bells' sharing obligations should include OPEBs. Verizon's PCIs do not factor into that equation, rendering Verizon's complaint that its PCIs never reflected OPEBs irrelevant.

In all events, even if compliance with the price cap rules did, as Verizon asserts, provide a safe-harbor against allegations of unjust and unreasonable rates, Verizon's argument fails because, as AT&T has demonstrated, the price cap rules in 1996 *did not permit* the Bells to retroactively restate prior years' rate bases and to seek exogenous cost adjustments to their 1996 PCIs and rates. *See* n.2, *supra.* Verizon and the other Bells 1996 tariffs thus did *not* comply with the price cap rules.

There Are No Policy Justifications For Allowing Verizon To Keep Its Overcharges. Verizon suggests that public policy considerations militate against issuing refunds and that Verizon should be permitted to keep the overcharges that it earned from its unlawful exogenous cost increases. *Verizon May 24, 2004 Letter* at 7-8. But as the Commission has repeatedly recognized, "[e]very customer has the right to be charged lawful rates." Memorandum Opinion and Order, 17 FCC Rcd 24201, *Communications Vending Corporation of Arizona, Inc., et al.* v. *Citizens Communications Company*, 17 FCC Rcd 24201, ¶ 47 (2002). The Bells, "having initially filed the rates and . . . collected an illegal return . . . .must . . . shoulder the hazards incident to [their] . . . actions including . . . refund[ing] of any illegal gain." *Id.* There is simply no legitimate basis for allowing the Bells, who were fully on notice that refunds would be required if their 1996 exogenous cost increases were ruled unlawful, to keep those amounts.

Verizon first claims that that it would be unfair to issue refunds because "Verizon was simply following the Commission's clear, contemporaneous instructions." *Id.* at 8. But, as demonstrated above, that is not true. Verizon's exogenous cost increases violated multiple Commission rules. Verizon next claims that it should not be required to issue refunds because the carriers that paid its overcharges recovered those overcharges from their own end user customers through increased rates in the unregulated long-distance markets. But that precise argument has been rejected by the Commission. *See* Memorandum Opinion and Order, 17 FCC Rcd 24201, *Communications Vending Corporation of Arizona, Inc., et al.* v. *Citizens Communications Company*, 17 FCC Rcd 24201, (2002). There, defendants argued, as Verizon does here, "that carriers should not receive a refund because they have already recovered from their customers the full [overcharge] . . . [and therefore] a refund would amount to double recovery." *Id.* ¶ 47. In rejecting that argument, the Commission explained that

> In a market with unregulated prices, the carriers were entitled to charge their customers a surcharge for per-call compensation or, indeed, to raise the retail rate to any level they think the market

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supported the Commission's findings. And there is no basis for the Commission to reverse those findings here.

> will bear. But the recovery of the surcharge does not undermine the legitimacy of the expectation that the carriers would eventually recover a refund because they paid an unlawful rate. . . . Carriers may have set their base rates or made other business plans in reliance on such an expectation, and we will not disturb those expectations because of the possibility of an appearance of double recovery. Indeed, the concept of double recovery is not particularly meaningful in a market where prices are not regulated.

Id. ¶ 47.

In any event, Verizon has provided *no evidence* that AT&T or any other carrier fully recovered these overcharges from end user customers. In fact, it is not even clear that AT&T and other carriers could have fully recovered the Bells overcharges through increased rates. Basic economics teaches that increased rates result in decreased demand. Therefore, even if AT&T and other carriers tried to pass on the Bells unlawful overcharges to end-user customers, the demand for AT&T's and other carriers' services would have declined which, in turn, would have reduced revenues. And Verizon has provided no evidence that, even if AT&T and other carriers increased rates, the corresponding revenues were sufficiently compensatory. This is fatal to Verizon's argument. *E.g.,* Memorandum Opinion and Order on Reconsideration, *1997 Annual Access Tariff Filings*, 13 FCC Rcd 10597, ¶ 9 (1998) (finding that "excessive . . . CCL charges . . . artificially depress[ed] demand . . [and] also . . . transfer[red] . . . revenues to the LECs from their potential competitors, the IXCs" and "refunds are necessary to protect end-users' and IXCs' interests in the development of competition and in obtaining just and reasonable toll calling rates")

Verizon's argument also fails on fundamental policy considerations. Permitting the Bells to keep tens of millions of dollars in overcharges would create additional incentives for Verizon and other carriers to implement unlawful tariffs that include substantial overcharges.

Respectfully submitted,

/s/ David L. Lawson

cc: Scott Bergmann
Laurel Bergold
Daniel Gonzalez
Christopher Libertelli
William Maher
Andrew Mulitz
Tamara Preiss
John Rogovin
Jessica Rosenworcel
Deena Shetler